COLUMBIA THREADNEEDLE INVESTMENTS

NOT JUST A MATTER OF STYLE: INTERNATIONAL STOCKS SHOULD SEE ROTATIONAL BENEFITS

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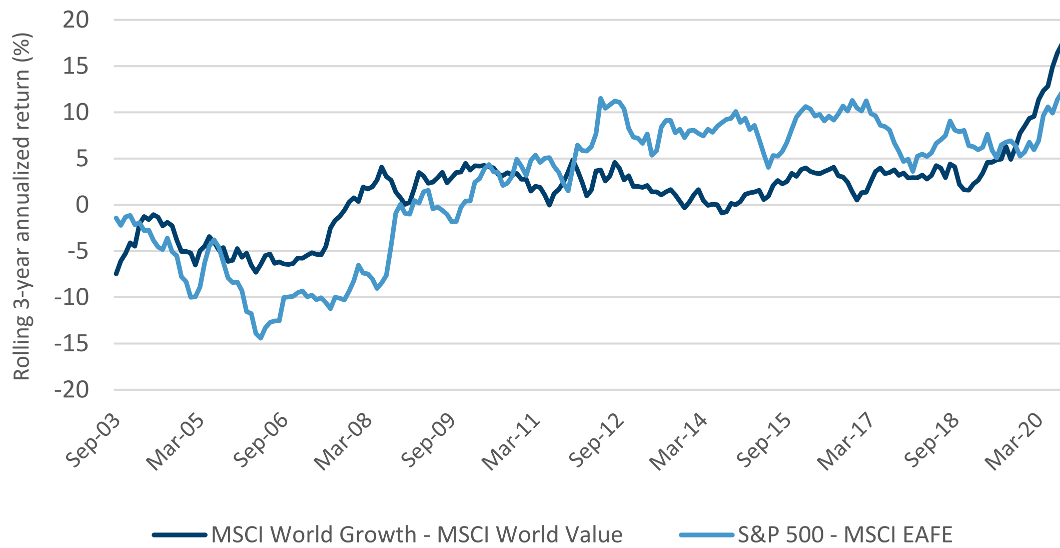
Recent counter-trend style rotations across many different market segments have once again increased focus on their sustainability. We believe they are sustainable — and non-U.S. markets, in particular, are poised to benefit from this new economic cycle.

The value/growth disparity has been well covered in recent years. Less talked about has been the relationship between non-U.S. stocks and the value cycle. Like value stocks, international stocks also underperformed relative to the S&P 500 over the past decade, influenced by many of the same dynamics. A potential reversal of those factors — higher cost of capital (which favors lower duration assets), a weaker dollar and a global economic expansion — in conjunction with a vaccine has placed non-U.S. markets, and undervalued stocks, in a very favorable position.

The relationship between value and international markets

There isn't as much manufactured in the U.S. as there used to be. It is now largely a service-oriented economy — and the stock market reflects that fact, being dominated by stable growth companies and secular growth companies such as the FAANG stocks. The U.S. has outsourced much of its historic production function to the rest of the world. When economic growth is slowing, that can be good news for the U.S. because aggregated earnings in the U.S. are, to a large degree, insulated from the cyclical effects of the economic cycle. The pain is felt most acutely by economies outside the U.S. that have taken up the manufacturing responsibility. However, we believe that when economic growth rebounds, the stocks and countries that have the highest degree of leverage to economic improvement and growth are going to be the ones that do best.

Exhibit 1: The growth premium and the U.S. premium — rolling three-year annualized excess returns



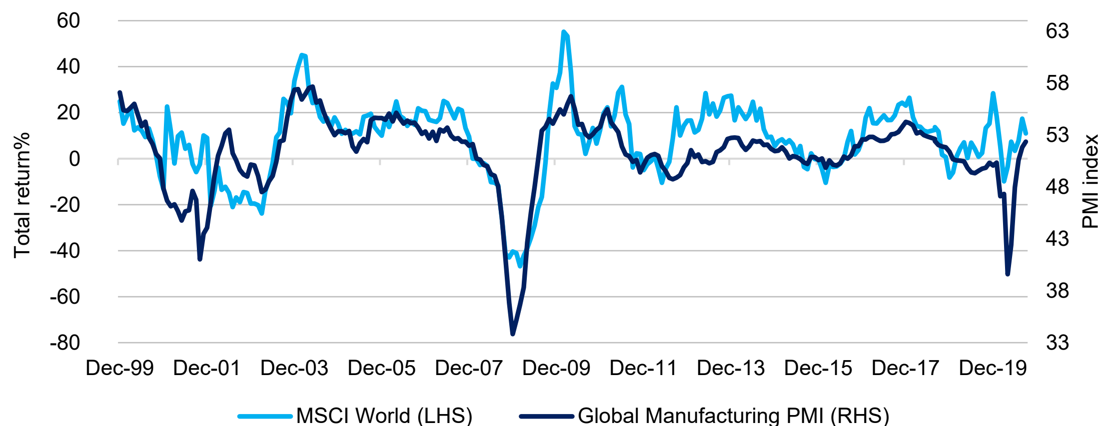
Source: Bloomberg; Columbia Threadneedle Investments. Excess returns equal MSCI World Growth Index minus MSCI World Value and S&P 500 Index minus MSCI EAFE Index; through November 30, 2020.

As Exhibit 1 indicates, the growth/value trade and the U.S./non-U.S. trade have been highly correlated, which is not a coincidence. The value cohort is highly cyclical in composition and therefore stands to benefit most in an environment in which economic growth is improving.

Value dynamics

The catalyst for value outperformance has very consistently been an acceleration in economic activity. As you can see in Exhibit 2, the market tracks leading indicators of the economy very closely. For related reasons, the growth/value cycle is also driven by the direction of the economy, with the link being earnings.

Exhibit 2: Markets track economies



Source: Macrobond and Columbia Management Investment Advisers, LLC, as of 9/30/2020. MSCI World Index is rolling one-year total returns.

Earnings are a commodity like any other. When they're scarce, they're worth more — and vice versa. When economic growth is slowing, earnings become scarce, and investors are willing to pay up for those companies that can deliver stable — if not growing — earnings. Conversely, when economic growth accelerates, earnings become more plentiful, and the market will typically no longer be willing to pay a premium multiple for stable growth. Instead, in that kind of environment, investors may seek to own the companies with the greatest degree of leverage to the improvement in economic activity. These are typically value stocks because, overwhelmingly, value stocks are the companies that have the greatest degree of leverage, be it operational leverage, financial leverage or both.

In our view, the key driver of changes in the trajectory of economic activity has consistently been changes in the cost of doing business, with lower costs motivating greater levels of activity. Falling interest rates, commodity prices and other proxies for the cost of doing business for the global economy represent stimulus and have had a historically reliable relationship with future trends in economic activity (Exhibit 3).

Exhibit 3: Economies track the cost of doing business

Source: Macrobond and Columbia Management Investment Advisers, LLC, as of 9/30/2020. The Global Columbia Economic Indicator is a proprietary Columbia Threadneedle analytical tool that uses market-based proxies for the concept of the cost of doing business, and how it is evolving, to predict changes in the trajectory of economic growth and therefore the stock market.

The path forward

Prior to the pandemic, our top-down framework indicated that economic activity was going to improve — after having steadily decelerated since the beginning of 2018 — as proxies for the cost of doing business had fallen. Since the onset of the pandemic, these proxies have collapsed — with energy prices even going negative on one contract, as a glaring example. From our perspective, this represents an enormous amount of stimulus in the system, which should ultimately boost economic activity. Clearly the pandemic has an ongoing dampening effect on the economy, but positive vaccine news should mitigate the still-high degree of uncertainty. As the global economy slowly reopens, the impact of a lower cost of doing business should continue to manifest in the form of improved economic activity. And as the market slowly gains confidence in the economic recovery, we foresee value stocks outperforming growth stocks and non-U.S. stocks outperforming U.S. stocks as a result.

Typically when these transitions occur, they're not gradual. They are dramatic. Portfolio positioning after the fact can therefore be difficult, as stock prices tend to respond quickly to this new environment.

Valuation, not just value, is the key

With discussion around value-oriented investment approaches intensifying, it is important to understand the distinction between the value style and a valuation approach to investing. A naïve value approach, based on a simple price-to-ratio sort, embeds a significant degree of cyclicality, because what's going to be cheap at any one point in time are the deep-cyclical, leveraged stocks. Therefore, the performance of value as a style, especially as captured by indices, is predominantly driven by the economic cycle. Valuation, on the other hand, is a comprehensive assessment of what an asset is worth — and what one pays for something will always matter. We believe that simple ratio comparisons (such as price-to-earnings or price-to-book) are not sufficient for a true determination of intrinsic value. The unique characteristics of the business model must be taken into account to properly value a company.

Chinese company Tencent Holdings, on a multiple basis, would be hard to justify as a value stock. However, the unique moat and monetization potential that the company enjoys could permit it to maintain high margins for far longer than most companies, allowing for sustained growth in cash flow and earnings. To properly value Tencent, or any other company for that matter, the trajectory of future cash flows must be considered, not just a current snapshot. This is the value-added approach of active management.

Conclusion

Any global recovery will be dependent on controlling the virus, which vaccine development will accelerate. We believe that the global economy will continue on its path of reopening, and global economic growth will continue to improve. Eventually, this will manifest in a rotation out of the defensive growth stocks that have been the leadership for quite some time, into more cyclical value names that have lagged, many of which are domiciled outside the U.S. So, if we're right in this call of steady economic improvement, then value will outperform growth, non-U.S. will outperform the U.S., and the U.S. dollar will weaken because the U.S. dollar is a counter cyclical currency, thereby boosting the returns to non-U.S. holdings.

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